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LEGAL RULING 2001-2

APPLICATION OF REVENUE AND TAXATION CODE SECTION 24405, SUBDIVISIONS (c) and (d), TO STATE-CHARTERED CREDIT UNIONS

ISSUE

What items of income of state-chartered credit unions are subject to California franchise tax?

FACTS

Credit Union A is chartered in the State of California and on December 31, YYYY, reports the following on its financial statements:

Assets

Loans to Members	\$70,000
Investments with Nonmembers	11,000
Investments	
with Member Credit Unions	25,000
Land and Buildings	<u>5,000</u>
TOTAL	<u>\$111,000</u>

Liabilities

Current Liabilities	\$1,000
Shares	100,000
Equity Capital	<u>10,000</u>
TOTAL	<u>\$111,000</u>

Income

Interest on Loans to Members	
(Before Refunds to Members)	\$9,000
Income from Reciprocal Transactions	
with Member Credit Unions	2,000
Nonmember Investment Income	180
Other income- Nonmembers	15
Other Income- Members	<u>30</u>
TOTAL	<u>\$11,225</u>

PURPOSE

On September 25, 1992, the Franchise Tax Board issued FTB Notice 92-7, relating to the application of Revenue and Taxation Code section 24405, subdivision (c), and the application of the alternative minimum tax to credit unions. Subsequently, Revenue and Taxation Code section 24405, subdivision (d), was added to the Revenue and Taxation Code.¹ Further, on January 7, 1999, in the *Appeal of San Francisco Police Credit Union*, 99-SBE-002, the State Board of Equalization (hereinafter the "Board") considered FTB Notice 92-7 and provided guidance for the proper application of Revenue and Taxation Code section 24405, specifically subdivision (c), pertaining to the investment of surplus member savings capital, and subdivision (d), pertaining to reciprocal transactions with member credit unions.

This ruling is intended to modify the portion of FTB Notice 92-7 that sets forth the methodology for application of Revenue and Taxation Code section 24405 rejected by the Board in *Appeal of San Francisco Police Credit Union*, *supra*, 99-SBE-002; however, the portion of FTB Notice 92-7 discussing the application of the alternative minimum tax shall remain in effect.

LAW AND ANALYSIS

Generally, credit unions are taxed as financial corporations. (Rev. & Tax. Code, § 23183; *Appeal of State Employees Credit Union No. 1*, Cal. St. Bd. of Equal., Dec. 13, 1961.) Revenue and Taxation Code section 24405, subdivision (a), however, allows a deduction for all income arising out of business activities for or with members of the credit union. Revenue and Taxation Code section 24405, subdivision (c), provides that income from investments of "surplus member savings capital" is also deductible. (See AB 1581, Stats. 1987, ch. 1465.) Additionally, the statutory history of section 24405, subdivision (c), clearly directs that investment income from "equity capital" remains taxable income of a credit union.² Revenue and Taxation Code section 24405, subdivision (d), provides that all income resulting from reciprocal transactions with member credit unions is income resulting from or arising out of business activities for or with their members, and accordingly is also deductible. (See AB 63, Stats. 1993, ch. 1121.) The issue for consideration in this ruling is the proper methodology to be used to determine, from the total nonmember investment income of a credit union, the amount attributable to "surplus

¹ Stats. 1993, ch. 1121, effective for income years beginning on or after January 1, 1993. Uncodified section 4 of AB 63 (Stats. 1993, ch. 1121) provides:

The provisions of this act shall apply to all open income years that are not closed by an applicable statute of limitations.

² Uncodified section 2 of AB 1581 (Stats. 1987, ch. 1465) provides:

It is not the intent of the Legislature to exempt, within the provisions of section 24405 of the Revenue and Taxation Code, "equity capital," as that term is defined in subdivision (b) of section 14400 of the Financial Code.

member savings capital," which is not subject to franchise tax, and the amount attributable to "equity capital," which is subject to franchise tax.

It might be concluded from the identified legislative history that all income attributable to "equity capital," as distinguished from income attributable to "surplus member savings capital," is intended to be in the taxable income base of credit unions. However, prior case law suggests that the nature of the underlying business transaction, rather than the source of the funds, dictates whether income generated is taxable or deductible. (See *Woodland Production Credit Association v. Franchise Tax Board* (1964) 225 Cal.App.2d 293, 300; *Long Beach Fireman's Credit Union v. Franchise Tax Board* (1982) 128 Cal.App.3d 50, 54.) Further, the legislative history to AB 1581, which added section 24405, subdivision (c), and the specific guidance from the Legislature with the adoption of section 24405, subdivision (d), indicate an intention to limit, not expand, prior case law pertaining to credit union tax liabilities. Of the nonmember investment income received by a state-chartered credit union, only that amount attributable to equity capital is subject to franchise tax. Therefore, it is necessary to identify a methodology for consistent application by the affected industry and the department to determine the appropriate amount of nonmember investment income that is deductible and the appropriate amount of nonmember investment income that is taxable, consistent with the legislative purposes in enacting the subject legislation and the interpretation and direction from the Board in the *Appeal of San Francisco Police Credit Union*, *supra*, 99-SBE-002.

The methodology set forth in this ruling, a proration formula, produces a consistent result by which only such income as is generated from activities with nonmembers is subject to tax, and that amount is further reduced to account for the statutory deduction authorized for investment income from "surplus member savings capital" investments, regardless of the underlying nature of the activities which generate that income.

"Nonmember Investment Income" is defined, for purposes of this ruling, as the investment income of a credit union, less investment income otherwise qualifying as deductible under Revenue and Taxation Code section 24405, subdivision (a) (e.g., interest income from loans to members, investment income resulting from reciprocal transactions with member credit unions, and other income from transactions with members).

"Surplus member savings capital" is defined in Revenue and Taxation Code section 24405, subdivision (c), as savings capital of credit union members which is in excess of the amount of savings capital which is loaned to members of the credit union. In accordance with the legislative direction provided at the time of adoption of Revenue and Taxation Code section 24405, subdivision (c),³ surplus member savings capital must be calculated without reference to equity capital, and in accordance with the position adopted by the Board in the *Appeal of San Francisco Credit Union*, *supra*, 99-SBE-002. Applying these guidelines, surplus member savings capital thus becomes member shares less member loans.

³ When Revenue and Taxation Code section 24405, subdivision (c), was adopted, the Legislature clearly expressed its intent not to exempt the income received from the investment of equity capital from franchise tax.

"Savings capital" is defined in Financial Code section 14400, subdivision (a), as payments made by members on shares, as set forth in the credit union's written savings capital structure policy.

"Equity capital" is defined in Financial Code section 14400, subdivision (b), as amended in 1998, as the "credit union's regular reserve account, the undivided earnings account, and any appropriated undivided earnings accounts."

REQUIRED METHOD

In the *Appeal of San Francisco Police Credit Union, supra*, 99-SBE-002, absent sufficient evidence of direct tracing, the Board directed the Franchise Tax Board to apply the formula set forth in FTB Notice 92-7, as clarified by the Board, to use the definition of equity capital set forth at Financial Code section 14400, subdivision (b), to use the definition of surplus member savings capital set forth in Revenue and Taxation Code section 24405, subdivision (c), and to use year end figures for both equity capital and surplus member savings capital in computing the allocation percentage.

The definition of surplus member savings capital set forth in Revenue and Taxation Code section 24405, subdivision (c), as clarified by the Board, is member savings capital less member loans, with no further adjustments. The definition of equity capital in Financial Code section 14400, subdivision (b), includes reserves and undivided profits. Generally, staff of the Franchise Tax Board will consider NCUA Form 5300 as the source for the amount of total shares and deposits (member savings capital), total loans (member loans), reserves and undivided earnings (equity capital).

The determination of nonmember investment income attributable to surplus member savings capital for a state-chartered credit union is a two-part process. First, the formula determines a percentage figure designed to reflect the percentage of total nonmember investment income attributable to surplus member savings capital. The amount of surplus member savings capital is to be divided by the sum of the credit union's surplus member savings capital and equity capital to produce an allocation percentage, which represents the portion of the credit union's nonmember investment income that may be deducted because it can be attributable to surplus member savings capital. Second, the allocation percentage is applied to the taxpayer's nonmember investment income to produce the proper amount of deductible income in accordance with Revenue and Taxation Code section 24405, subdivision (c).

The required methodology allocates total nonmember investment income, as defined, in accordance with the following formula:

$$\begin{array}{lclcl} \text{Nonmember} & & \text{Surplus Member} & & \\ \text{Investment Income} & \times & \frac{\text{Savings Capital}}{\text{Surplus Member Savings Capital} + \text{Equity Capital}} & = & \text{Section 24405, Subdivision (c) Deduction, Nonmember Investment Income Not Subject to Franchise Tax} \end{array}$$

The remaining nonmember investment income is considered to be attributable to equity capital and is thus subject to the franchise tax. The formula for determining the taxable portion is:

Nonmember

$$\text{Investment Income} \times \frac{\text{Equity Capital}}{\text{Surplus Member Savings Capital} + \text{Equity Capital}} = \text{Nonmember Investment Income Subject to Franchise Tax}$$

The foregoing approach makes the assumption that the source of capital for any particular investment option selected by a credit union cannot be directly traced. However, if direct tracing of either surplus member savings capital or equity capital to particular income generating assets can be established, the income from such assets will be taxable or deductible based on the nature of the source of the investment.

Since money is, as a practical matter, a fungible commodity, the source of funds representing any particular investment might be made up of dollars from transactions with members, retained earnings, nonmember loans to the credit union, or reserve funds. Absent adequate evidence of direct tracing, it is necessary to use a proration formula to determine the allocation of investment income to the particular available sources from which the investments are made. In so doing, it is appropriate to limit the ratio components to those relevant to implementing the legislative intent behind Revenue and Taxation Code section 24405, subdivisions (c) and (d), distinguishing between investment income generated from surplus member savings capital and investment income generated from equity capital.

It is the department's position that the methodology set forth above properly advances the purposes of Revenue and Taxation Code section 24405, subdivisions (c) and (d), while retaining the prior legislative, judicial, and Board directives and authority to tax income generated from nonmember transactions of state-chartered credit unions. As previously noted, the legislative intent surrounding enactment of the statutes at issue cannot be viewed as intending to completely exempt credit unions from tax, since had that been the legislative intent, full exemption from franchise tax would have been provided at that time.⁴ In adopting this position, careful consideration has been given by the department to the notion that the primary purpose of credit unions is both to promote thrift concerning its members and to create a source of credit for these members. (See Fin. Code, § 14002.) The department further believes that the conclusions expressed herein are consistent with the purposes and concerns of the prior legislative activity in this area, which is to ensure that credit unions are able to provide a source of credit to members while simultaneously advancing the ability of credit unions to pay competitive returns on

⁴ This is exactly the result of Senate Bill 934 (Stats. 1999, ch. 675). This act, effective for income years beginning on or after January 1, 1999, allows a credit union, as defined in Financial Code section 14002, to qualify for exemption from franchise or income tax under the Bank and Corporation Tax Law, sections 23701 and 23701y.

member shares, keeping in mind that competitive savings rates of other financial institutions are generated fully with after-tax returns.

Income received by state-chartered credit unions as the result of services provided to nonmembers or as the result of other transactions with nonmembers continues to be subject to franchise tax.

Applying the methodology prescribed in this ruling to the facts presented for Credit Union A yields the following results:

The Nonmember Investment Income for Credit Union A is \$180.

Surplus Member Savings Capital is Shares minus Loans to Members, or \$100,000 less \$70,000 = \$30,000.

Equity Capital for Credit Union A is \$10,000.

Nonmember Investment Income excluded from franchise tax by Revenue and Taxation Code section 24405, subdivision (c), for Credit Union A is thus computed as follows:

$$\begin{array}{rcccl} \$180 & \times & \frac{\$30,000}{\$30,000 + \$10,000} & = & \$180 \times \frac{3}{4} = \$135 \end{array}$$

Accordingly, the amount of nonmember investment income subject to franchise tax is nonmember investment income, or \$180, less the Revenue and Taxation Code section 24405, subdivision (c), deduction, or \$135, which leaves \$45 of nonmember investment income subject to franchise tax.

Additionally, income received by state-chartered credit unions as the result of services provided to nonmembers or as the result of other transactions with nonmembers, in this example \$15, continues to be subject to franchise tax. The total amount of income subject to California franchise tax for Credit Union A is \$45 plus \$15 = \$60.

HOLDING

The Revenue and Taxation Code section 24405, subdivision (c), deduction for nonmember investment income attributable to surplus member savings capital, and not subject to California franchise tax, shall be determined in accordance with the following formula:

$$\begin{array}{rcccl} \text{Nonmember} & & \text{Surplus Member} & & \\ \text{Investment Income} & \times & \frac{\text{Savings Capital}}{\text{Savings Capital} + \text{Equity Capital}} & = & \text{Section 24405, Subdivision (c) Deduction} \end{array}$$

EFFECT ON OTHER DOCUMENTS

FTB Notice 92-7 is modified as described herein.

DRAFTING INFORMATION

The principal author of this ruling is Edward J. Kline of the Franchise Tax Board, Legal Branch. For further information regarding this ruling, contact Mr. Kline at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720.